Nos. 10,589, 10,590, 10,591, 10,592

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

4

NEW IDRIA QUICKSILVER MINING COMPANY (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,589
KLAU MINE, INC. (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,590
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WILD HORSE QUICKSILVER MINING CO. (a corporation), *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 10,592

On Petition for Review of Decisions of the Tax Court of the United States.

PETITIONERS' REPLY BRIEF.

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I.

THE HISTORY AND RATIONAL INTERPRETATION OF "GROSS INCOME FROM THE PROPERTY".

Respondent throughout his brief stresses the idea that the words "gross income from the property" are equivalent to the "market or field price of the raw material before conversion" (R. Br. 14), and again that it is equivalent to the "gross income from the raw product". (R. Br. 18.) Then he stretches gross income from meaning the returns from sales of the raw mineral product or market value of a salable product to a calculated value of the product at the mouth of the mine. He says (p. 20):

> "In the face of the legislative history detailed above we think it impossible for anyone to maintain that, by the 'extension' of percentage depletion to metal mines, Congress intended to authorize depletion upon the enhanced sale price of an ultimate product which is the result of applying—to the raw mineral product brought out of the mine—non-excepted processes, whether refining, manufacturing, or otherwise. The fundamental purpose of a depletion deduction was a compensatory allowance to owners, on account of severance of their natural resource when consumed in the production of income, and this is just as true where the statute allows a deduction based on 'gross income from the property' as where the depletion is based on cost or on discovery value."

He goes on to say (p. 21):

> "Ordinarily a market price exists for the raw mineral product as it is produced. Where this is so the 'gross income from the property' is the

> sale price of *the crude mineral* product in the immediate vicinity of the mine or well. One object of the Regulations is the determination of an equivalent of such fair market price for the raw product in instances where elaborate processing of the crude mineral is necessary to get a marketable product."

We dispute both the respondent's summation of legislative history and his interpretation of what Congress intended to accomplish by percentage depletion. In support of this position we advert to an authority whom we think respondent himself will endorse.

Mr. Randolph E. Paul, now general counsel for the Treasury at all hearings on income tax laws before the Congressional committees, in 1934 joined with Mr. Jacob Mertens, Jr. of the New York Bar in writing an exhaustive work on the Law of Federal Income Taxation. In volume 2, section 21.53 of this work, the history of depletion allowances in metal mines is briefly and comprehensively stated as follows (pp. 755-756):

> "Section 21.53. *Discovery Depletion Generally.* At the instance of the oil and mining companies there was inserted for the first time in the 1918 statute a provision for a more favorable treatment of taxpayers *discovering* mineral properties, giving such taxpayers the benefit of depleting the value at the date of discovery, or within 30 days thereafter. The valuation was required to be made as of this period and not as of a subsequent period, and constituted a basis for

depletion, and not for gain or loss on the sale of properties.

At the time the 1921 statute was in the process of enactment it was deemed that the previous statute treated discoverers more favorably than had perhaps been intended and the result was a limitation that the depletion allowance based on discovery value should not exceed the net income from the property upon which the discovery was made. This limitation was dropped from 100% in the 1921 Act to 50% of the net income in the 1924 Act. In the 1926 Act Congress showed its dissatisfaction even with the limitations it had adopted and departed altogether from the discovery provision with respect to *oil and gas* properties, inserting in lieu thereof a flat or arbitrary 'percentage depletion' of 27½% of the gross income from the property and 50% of the net income. The discovery provisions were continued with respect to mines with some changes in definition of discovery.

The 1928 Act continued percentage depletion in the case of oil and gas wells and valuation discovery depletion in the case of mines. Substantial changes were made in the 1932 Act. Percentage depletion was extended to coal, metal and sulphur mines—5% in the case of coal mines; 15% in the case of metal mines; and 23% in the case of sulphur mines—these percentages being based, as in the case of oil and gas properties, upon the gross income from the property and being also limited to 50% of the net income."

In a footnote to the above statement, Mr. Paul's work quotes a former solicitor of the Bureau as follows (p. 756):

> "In Hearings before the Congressional Committee investigating the Bureau of Internal Revenue, it was said in 1925 by A. W. Gregg, formerly Solicitor of Internal Revenue: 'If something could be done in the law to do away with the necessity for valuing mineral properties for the purpose of determining depletion, it would be the biggest thing that has ever been done for the Bureau of Internal Revenue'.
>
> Much was accomplished by the elimination of discovery valuation except in so far as it still remains in a relatively unimportant way."

From the foregoing quotation it will be seen that what Congress was trying to do in extending percentage depletion to metal mines was to get away from the uncertainties which had been attendant upon attempts to value mineral in place. Discovery depletion had been thoroughly unsatisfactory to the Treasury, and the principal reason for that dissatisfaction, it may be assumed with reasonable certainty, was the difficulty which Treasury representatives had had in combatting the valuation figures of experts for mineral-producing taxpayers who were undoubtedly much more familiar with the properties than the Treasury representatives could have been. Congress said that the basis for percentage depletion would be "gross income from the property". It did *not* say the basis would be "calculated hypothetical sales value of an unsalable raw material in transit from its original status as ore in place to its first marketable form". What Congress sought to accomplish through the extension of percentage depletion to metal mines was

an elimination of these uncertainties, and to accomplish, by a simple reference to gross receipts from the sale of the first marketable product, a clear-cut basis for computing depletion. It selected a percentage for application to this basis *which took into account the fact* that certain mining and milling processes would normally have to be completed in order to obtain a marketable product. It is notable that in the case of oil wells where capital costs are relatively heavy and production costs relatively low, 27½% was adopted as the basis for percentage depletion. In the case of metal mines only 15% was allowed. In both cases an alternative limit of 50% of the net income from the property, which had applied since 1924 under discovery depletion, was carried forward in the percentage depletion acts. It was undoubtedly true that Congress did not intend to allow depletion on the cost of processing crude products beyond their first marketable form, but by the same token it did not intend to disallow depletion on the sales value of a mineral product whose first marketable form might be pure metal. Frequently in high grade gold mines gold nuggets or high grade quartz are mined which produce gold in its native form. Congress did not intend to penalize the owners of such mines because their first marketable product was in the form of pure mineral. It did not do so in the case of high gravity oil fields. When it came to metals that are ordinarily sold either in the form of their ores or of their concentrates, it undoubtedly intended that the gross income should be computed on the current sales price of such ore or concentrates,

and that no discrimination should be made in favor of producers who not only brought their product to the stage of the first marketable product, but continued refining processes to a much greater extent and produced a still more valuable marketable product by so doing.

It is our earnest belief that the Treasury in first promulgating its Regulations intended to accomplish this same result; that in all of the provisions of Regulations No. 103, Section 19.23 (m)-1-(f)-(4), the use of the words "beneficiate" and "beneficiation" was intended in an *economic* rather than a *physical* sense. The specification of "lead, zinc, copper, gold and silver" ores shows that what the Treasury had in mind was that the producers of those ores should not be allowed to deplete a cost of processing which took them beyond what is usually, though not always, the first marketable product, viz., concentrates, ready for the smelter. The Regulation does not mention mercury, and the reason probably is that at the time the Regulation was promulgated the mining of quicksilver in this country, due to foreign cartel competition, was at a very low ebb and no quicksilver mining cases had been brought to the attention of the Treasury. When the present cases finally arose the respondent was confronted with a situation where the Regulation above referred to if applied in a purely physical sense did not provide for depletion of the gross income derived from sale of the first marketable product. Instead of interpreting the language of the Regulations in an economic sense, respondent took it

in a literally physical sense and the Tax Court followed him in this respect. We submit that it was a gross distortion of the intent of Congress to do so. No authority cited by respondent supports such an interpretation, and it is therefore meaningless to say that subsequent reenactments of the statute gave it weight.

II.

FURNACING DOES NOT BENEFICIATE QUICKSILVER ORES MORE THAN GRAVITY CONCENTRATION IN AN ECONOMIC SENSE.

In his brief (p. 6) respondent urges that the Tax Court found that the processes of furnacing the crushed cinnabar ore and condensing, cleaning and flasking the mercury vapors obtained from such operation " 'beneficiated the product in a greater degree than "crushing" and "concentrating" ' the cinnabar by the gravity or flotation method," and that this finding is not open to attack. The petitioners' witnesses, all of whom were well qualified to speak, testified *without contradiction* that the concentration of mercury ores by furnacing and condensation was a purely physical process and was comparable, in its economic effect in obtaining from the ore the first marketable product, to concentration of gold and silver ores by gravity. They testified that concentration by gravity of quicksilver ores had been attempted but had not produced a marketable product, and that it was still necessary after such concentration to furnace the concentrates and condense the vapors

therefrom, and even then there would not be as high a recovery as would be obtained by furnacing the ore direct. In a physical sense therefore it is of course true that the furnacing of the ore beneficiated it to a greater extent than the concentration by gravity because gravity concentration did not beneficiate the ore at all. The concentrates have no sale value. Concentrating merely eliminated some waste material. The concentrates still have to be furnaced. Due to the loss of metal in the concentrating process, there would be less return to the producer after gravity concentration followed by roasting than by directly furnacing the crude ore without concentration. The Tax Court's finding amounts to nothing more than an assertion of the self-evident fact that the producers could (though none of them do) adopt an uneconomical method of beneficiation under which furnacing might follow concentration, and therefore constitute further beneficiation in a physical sense. However, the Tax Court did not find, and no witness testified, that furnacing of quicksilver ore in an economic sense—that is, in the production of a marketable product—accomplishes anything more than gravity concentration of gold and silver ores effects. A comparison of the value of metallic mercury with the value of gold and silver concentrates would of course be meaningless, but a comparison of the economic condition of the product, namely, its readiness for market, shows that the furnacing of quicksilver ore accomplished exactly what the gravity concentration of most gold and silver ores would accomplish and nothing more.

It beneficiates the crude ore to its first marketable form.

The testimony which we have summarized is found in the statements of Walter Bradley, State Mineralogist (R. 71-72); Worthen Bradley, President of Bradley Mining Co., operating the Sulphur Bank Quicksilver Mine (R. 75-77); and H. W. Gould, General Manager of the New Idria Quicksilver Mine. (R. 80.) All of the authorities cited by respondent are analyzed and quoted in our opening brief. Petitioners there draw conclusions from them at total variance with those of respondent and the Tax Court.

We may summarize briefly the arguments under the heading of the first two sections of our brief as follows:

(1) That historically percentage depletion was intended to substitute for the uncertain and speculative computations of discovery depletion, a certain definite basis ascertainable from the taxpayer's books, which when multiplied by the allowed percentage, would give an approximate compensatory deduction for the wastage of mineral land capital value due to production.

(2) That it was not the intent of Congress to carry that base back to the value of the ore in place. That is what discovery depletion did. To do so involves many of the objectionable hypothetical calculations which caused discovery depletion to be discarded. It was rather the intent of Congress in 1932 and in subsequent acts to establish a market sales value base

for the first *marketable* product of the mine, to which statutory fixed percentages could be applied, thereby allowing the taxpayer an approximate compensable deduction from income for capital wastage, and thereby avoiding the taxing of capital under the guise of income.

(3) That the physical condition of the product was not a matter of any concern to Congress, but its economic condition was the determining factor. When the ore was reduced to a stage where it could be sold at a definite market price, then "gross income from the property" could be accurately computed on the basis of the sales value in that form, and a depletion basis determined upon that computation rather than upon engineering estimates of valuation or theoretical apportionment of costs and profits.

(4) That in retaining the 50% net limitation, Congress provided adequately for protection of the Government in those cases where high sales prices might be incident to or caused by certain extensive mining or high processing costs required to bring the product to a marketable stage. In such cases the 15% of the gross income might well be, and frequently is, in excess of 50% of the net income, but the taxpayer would only get the latter deduction.

(5) That the attempt of the respondent in this case to subtract processing costs essential to bring the product to a marketable form and then to allow a deduction of only 15% of the residual income after subtracting those costs (plus hypothetical profits)

does violence to the obvious intent of allowing 15% of the *gross* income as the upper alternative. As pointed out in our opening brief, what the Commissioner has done is in effect to apply the *15%* to *net income plus the cost of mining,* where Congress intended *50%* to be the alternative allowable percentage of net income.

III.

PETITIONERS' ARGUMENT RESPECTING THE ARBITRARY, SENSELESS APPORTIONMENT AND DEDUCTION OF PROFITS REMAINS UNANSWERED.

No argument in this case has had less logical justification than the argument contained in respondent's brief, pages 25-27, with respect to the allocation of profits to mining operations. Respondent seems unable or unwilling to realize that profit from mining operations is not based on the cost of mining. It is simply reduced by the cost. Metals have a value in a world market. For the most part, that value is wholly unrelated to the cost of production. It depends upon supply and demand, upon the scarcity or abundance of the metal in question and upon the value of the uses to which it may be put. The other principal factor is the quantity and degree of concentration of the metal in place and its accessibility to market. These factors cause the profit. The metal has to be mined. This costs money. It has to be processed to a greater or lesser extent to obtain a marketable product. This costs money. These costs

reduce the profit. But except where processing is carried beyond the first marketable product stage by commercial smelters or processing plants, there is no profit attachable to the operations themselves. It is the ownership of the mine or the ore in it and the market price of the product which determine whether or not there may be a profit on production of said ore after deducting the costs necessary therefor. If the ore were fully blocked out in the mine most of the net profit might be realized from a sale of the mine itself instead of producing it. The attempt to segregate this over-all profit according to the cost of different operations is shown in our opening brief to be productive of ridiculous results (Opening Brief pp. 42-44), and no attempt has been made by either the respondent or the Tax Court to overcome the force of these arguments. Respondent contents himself with reiteration (p. 25) that the profit is the result of mining, further processing, refining and manufacturing operations, including transportation. We would be interested to see the respondent or anybody else try to base the selling price of his mineral product on such considerations. His price would either be away below the market, with consequent loss to himself, or away above the market, in which case he would have no takers for his product.

IV.

CONGRESS HAS NOW FULLY CORROBORATED PETITIONERS' POSITION AND REBUKED THE TREASURY, BY INCORPORATING RETROACTIVELY IN THE 1943 REVENUE ACT THE VERY DEFINITION OF GROSS INCOME FROM THE PROPERTY WHICH PETITIONERS CONTEND HAS ALWAYS BEEN THE INTENT OF THE PERCENTAGE DEPLETION SECTIONS.

We include a copy of the amendment to Section 114 (b) (4), which has just been passed by Congress over the President's veto, in the Appendix to this brief. It expressly directs that gross income from mining quicksilver ores shall include the furnacing of the same, and this provision is made retroactive to all taxable years beginning after December 31, 1931. So far as we can see, this ends the dispute and entitles petitioners to a reversal of the Tax Court in this case. Respondent may quibble that the word "furnacing", as used in this case, was separated from "condensing, cleaning and flasking". This separation of costs was made by the petitioner taxpayer at the instance of respondent's representatives. The word "furnacing", like the word "milling", ordinarily includes all of the operations which take place in reduction of quicksilver ore to a marketable product. Technically speaking, the heating of the ore in the furnace would reduce its mercury content to a vapor form, which could not possibly be handled, to say nothing of being sold, until it was condensed in the condensers which are connected with the furnace and poured into flasks, after being cleaned of soot and other impurities. The cost of these latter operations

is quite small compared with the furnacing cost as segregated in this record (R. 8 and 37-47), and in the stipulation of facts in typewritten records in the consolidated cases. The obvious intent of Congress, as shown in the amendment to Section 114 (b) (4) of the Revenue Code by adding a definition of gross income from the property was to insure that mine owners were allowed depletion on those operations which are normally applied to obtain *commercially marketable mineral products. The amendment so states.* The condensing, cleaning and flasking of the quicksilver is just as essential to obtaining a commercial marketable product as is the roasting of the ore in the furnace. We submit therefore that the word "furnacing" as used in the new Act was intended to and does include all of the processes, the cost of which, with assigned profits, have been deducted by the respondent herein. Inasmuch as the amendment is made retroactive to cover the years involved in these cases, it amounts to a congressional mandate for the reversal of the Tax Court's judgment herein.

V.

THE NEW IDRIA DUMP ORES ARE DEPLETABLE.

Respondent in his brief makes one or two statements with respect to these dump ores which, we submit, are not supported by the evidence. He says (page 29) that New Idria "found" these ores in great piles or dumps upon its land when it acquired the land in

1936, the implication being that they were simply a new discovery not involved in consideration of the purchase price which New Idria paid for the properties. There is no evidence justifying such an assumption. It is a safe inference that the existence of these dumps was just as well known to New Idria when it bought the properties and probably better known than the existence of ore in place underground. At page 30 of his brief respondent states that the dump material was not a part of any mine when New Idria bought it or thereafter. There is no evidence to support that statement. On the contrary, the stipulated facts are that the dump material was always a part and parcel of the property from which it was taken, and that the right to further mine and process the material in the dumps passed down from owner to owner in exactly the same way as the right to mine and extract ore in place. The suggestion that New Idria has no economic interest in the ore in those dumps because they were mined by its predecessors in interest is to us a suggestion without meaning. New Idria acquired through its predecessors in interest every single right that they had ever had with respect to those ores, including the economic interest therein. There never had been any severance of the titles or the right to mine and further process said ores in the dumps from the right to mine and process them when they were in place in the ground. No right to deduct for depletion of the mine by extraction of ores had ever been exercised by any predecessor in interest. Therefore that right to take percentage depletion on the residual income therefrom

passed to New Idria when it acquired the property. This is not a case where the acquisition of a predecessor's cost basis for depletion is involved. It is a case where the right is involved to deduct on a gross income percentage basis for depletion of the mineral value of the land. Part of that mineral value is in the dump ores still located on and unsevered in title from the lands from which the ores were taken. What principle in reason, in justice, in statute or in the regulations should deprive the petitioner herein of the right to claim depletion on this value? We can find none. The extension of the ruling in *Commissioner v. Kennedy Mining & Milling Co.*, 125 Fed. (2d) 399 (C.C.A. 9), for which we contend in our opening brief, to the situation in the instant case will create no undesirable precedent, will not deprive the Treasury of one cent to which it was ever entitled, and will insure ordinary justice to this petitioner in taxing its income rather than its capital.

VI.

THE OAT HILL POWER DEDUCTION WAS PROPER.

The suggestion in respondent's brief, page 32, that Oat Hill Mine, Inc. has probably been repaid the $3750 deposit for power service is contrary to facts. It has not received, and never will receive, the deduction because the mine was closed down within just about the period estimated by the witness Gould. The suggestion that an estimate of this period was too speculative and indefinite to support any deduction

allowance is no answer to the argument that the deduction in question was purely an operating expense paid for electrical service for which no reimbursement was estimated to be due. Respondent offered no evidence to rebut the estimated life of the operation as given by petitioner's witnesses. We submit, therefore, that the deduction should all be allowed for the year in which it was paid, or else spread over this estimated period.

CONCLUSION.

The right to percentage depletion may be a "grace" of Congress. Nevertheless it is a grace founded upon sound reasoning, namely, that an income tax law shall not be made the basis for taxation of capital. Other provisions of the tax law, such as the excess profits tax, are designed to convert into the Federal Treasury any part of petitioners' income which may be unduly incremented by war conditions. Percentage depletion stands as a vested right given to petitioners by Congress to protect the wastage of their capital assets from being taxed as income. Percentage depletion was always intended to be calculated on the definite ascertainable basis of the market value of the first salable product. We think a correct interpretation of the Treasury regulations justifies this conclusion. Certainly the amendment to the revenue laws just enacted by Congress fully establishes this principle and reaffirms the construction placed on the sections in the Senatorial debate quoted in our opening brief. It necessarily follows that petitioners are right in

their appeal in this case, both in principle and in reliance upon the new retroactive statute.

The judgment of the Tax Court should be reversed and all of the additional assessments made by the respondent disallowed.

Dated, San Francisco, California,
March 3, 1944.

Respectfully submitted,
ROBERT M. SEARLS,
Attorney for Petitioners.

(Appendix Follows.)

Appendix.

Appendix

Section 124 (c) of the Revenue Act of 1943—Passed by Congress over a Presidential veto February 25, 1944.

Section 114 (b) (4) is amended by adding at the end thereof the following:

> "(b) *Definition of Gross Income From Property.* As used in this paragraph the term 'gross income from the property' means the gross income from mining. The term 'mining', as used herein, shall be considered to include not merely the extraction of the ores or minerals from the ground *but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products.* The term 'ordinary treatment processes', as used herein, shall include the following: (i) In the case of coal—cleaning, breaking, sizing, and loading for shipment; (ii) in the case of sulfur—pumping to vats, cooling, breaking, and loading for shipment; (iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals which are customarily sold in the form of a crude mineral product—sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment; (iv) in the case of lead, zinc, copper, gold, silver, or fluorspar ores, potash, and ores which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic,

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(NOTE): Italics supplied for emphasis of relevant clauses.

or magnetic), cyanidation, leaching, crystallization, precipitation (but not including as an ordinary treatment process electrolytic deposition, roasting, thermal or electric smelting, or refining), *or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore, including the furnacing of quicksilver ores. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 731 and 735.*"

"(d) * * * A provision having the effect of the amendment made by subsection (c) shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after December 31, 1931."